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EP68 | Playing the plan: Mawer's Canadian small cap portfolio

Disclaimer	**00:25**	This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time, and are subject to change.
Andrew Johnson:	**00:41**	Samir, welcome to the podcast. How are you?
Samir Taghiyev:	**00:43**	I'm good, Andrew. How are you?
Andrew Johnson:	**00:45**	I've been doing well. I've been able to adjust pretty well to working from home. Still able to meet with clients over video, host the podcast like we are now. So, in that sense, I think things have been okay, relatively speaking.
Samir Taghiyev:	**00:56**	Good.
Andrew Johnson:	**00:57**	This is your first time on the podcast—let's get to know you a bit. Can you tell us a bit about yourself?
Samir Taghiyev:	**01:01**	I'm Samir, I'm part of the Canadian small cap team. The other half of the team being Jeff Mo, who's been on this podcast before. I've been at Mawer for six years now, four of which have been with the Canadian small cap team.
Andrew Johnson:	**01:15**	Give our listeners a sense of where your passion for investing came from. Or even how you ended up at Mawer.

Samir Taghiyev: **01:20** I would say that a lot of people in this industry seemed to have passion for investing growing up. It wasn't the case for me, I didn't even think of investing as a career path growing up. Where I discovered investing was really in my university years. So joining university, at the University of Toronto, in my first year I was really curious about different clubs and different courses. I would join courses starting from anthropology, to biology, just to see what it's like. The same goes with the clubs as well, so one of the clubs was the student-run investment club. As soon as I joined, I knew that it's something that interest[ed] me well. It is a very fascinating topic, to analyze different businesses. And also, you get to meet very interesting people who are passionate about it, too.

Andrew Johnson: **02:10** Great. Well, I know that we've been very fortunate to have you on the team for the last six years, so thanks for sharing that with the listeners.

02:16 I've been talking with some of our teammates on the podcast about the pandemic, just generally speaking, and the economic and the market reactions that we've seen from that.

With your work on the Canadian small cap portfolio, how is all of that affecting your portfolio? And maybe more broadly speaking, the universe that you're selecting stocks from?

Samir Taghiyev: **02:36** So from an economic perspective, we're going through a recession, and it's different than a usual recession. If you think about other recessions, it would be a more business-cycle driven or credit-cycle driven recession. This recession is really driven by the health policy by the governments, and that makes it very sharp, because a lot of the businesses had to stop their business activities. It also makes it very deep as well, so if you look at unemployment rates for example, they are 15-20% percent across Canada and the U.S. So very unprecedented, or [a] very sharp contraction of economic activity.

03:18 What we've seen with the businesses that we own, a lot of them have been impacted. For the businesses that we own in the portfolio, the ones that have been customer-facing, so that would be restaurant franchising businesses, or airline-related, where they've been really hit by the lockdown rules, that has been the direct economic impact to their businesses.

Samir Taghiyev: On the offset, we've also seen large actions by the central banks and the governments, in order to soften the blow. This is different from the previous recessions as well, where it takes a while for the governments to react, [whereas] this time around, the governments really have taken big actions almost right away.

04:03 Especially with the central banks—they recognize that this cessation of business activity is really bad for liquidity, so there's concerns on that. So what they've done is they've pumped a lot of liquidity to the system, which has helped. So you've seen the sharp market correction at first, but then as the governments reacted to this, the markets went back to normal.

Andrew Johnson: **04:25** When we look at the portfolio itself, so the New Canada Fund as you mentioned, what parts of the portfolio have held up relatively well?

Samir Taghiyev: **04:32** I look at that from the lenses of fragility, resilience, and antifragility. If you apply those lenses to the businesses that you would describe as "fragile," [those] have performed worse. So, these would be businesses that do not really behave well in turbulent times, which we're going through right now as well. Versus the businesses that are more resilient have performed better. And you can see that in stock performances, as well.

Andrew Johnson: **05:02** Resilience is a word that we actually talk about a lot around the firm. Maybe share with our listeners just what are some of the hallmarks of a resilient business model that we're looking for?

Samir Taghiyev: **05:13** Our general investment philosophy, which is to buy businesses that are wealth-creating, and doing so sustainably over longer periods of time, and that have management teams that can create that value, and buying these stocks at reasonable prices—that is really the features of the resilient business model.

05:32 If you'll look at a lot of these businesses, they have recurring cash flows, they're critical to customers' operations, or to customers' lives, they have stable cash flows. That would be [some] of the features.

Andrew Johnson: **05:46** Yeah, so tend to generate steady amounts of cash, tend to retain some of that cash as well. Just in terms of capital-light business models, just not having to use a lot of cash to run the business, and seem to be less discretionary in nature. Is that fair?

Samir Taghiyev:	**06:02**	That's correct. One of the examples of that would be software businesses that we own in our portfolio, and we own more than the index, really, out there. The reason why is because a lot of these software businesses do exhibit these features. They're recurring, they're very critical to customers, and they're capital light. They also tend to have better balance sheets as well, which helps them to go through turbulent times like these.
Andrew Johnson:	**06:31**	Just very quickly—you also mentioned the words fragility and antifragility. I just wanted to clearly define those for the listeners. What do you mean by those two terms?
Samir Taghiyev:	**06:40**	These terms really describe the way systems behave to volatility, or to change. These terms were coined by Nassim Taleb in his book Antifragile. The "fragility" would be companies that are not behaving well with volatility, so, many examples would be commodity producers who cannot control their prices, or they would have lower margins, higher capital intensity. Many times, high indebtedness.
	07:09	So what these business survive on is, really, stability. As long as the environment is stable, they will be out there, they will be fine. But, the world is not stable for a long period of time, and as soon as the volatility hits, their fragility really is exposed. Versus, on the other hand, the "antifragility" [which are] businesses that really strive on these changes in the environment.
Andrew Johnson:	**07:33**	You mentioned balance sheets, and I think often times a good, strong balance sheet, or the maintenance of a balance sheet, often comes down to the management team. I wanted to get an understanding of your view on the management teams within the Canadian small cap universe, in general, and maybe in particular our portfolio.
Samir Taghiyev:	**07:50**	I would say that our portfolio has a greater share of entrepreneurs there, rather than the universe. That is by design: again, one part of our philosophy is really aligning ourselves with greater business people, greater managers. And entrepreneurs/founders of businesses typically tend to be greater businessmen, I would argue.
	08:11	So, where does that come into play? They are typically around for a longer period of time. They've built these businesses, in many cases, for decades. They have gone through many times of turbulence, they have seen this music play a few times, so they are cognizant of the balance sheets.

Andrew Johnson: 08:29 Well, often times it comes down to both—one alignment with the actual business outcomes, because they have a larger stake in the business because they founded it, or they've been owning it within the family for a long time. But, they also have a true passion for running the business. They've started this for not just the money, but to deliver a service or a product.

Samir Taghiyev: 08:47 So, where does the balance sheet come into play, with management teams? These management teams have been around for longer periods of time, and they've seen volatility before. They've been around for longer periods of time, and they understand the importance of [the] balance sheet in survivability of the business, and also the ability to capitalize on opportunities as well. What is important, is, a lot of times, the best opportunities present themselves in more turbulent times as well.

09:15 What matter is, really, the relative balance sheet position. If you think about, if your balance sheet is full of cash, no debt, but your competitors are also in the same position, that does not really create you a lot of opportunities. The competitors will be able to do well, and survive, and everyone will be able to capitalize on the same opportunities. Versus if you have better balance sheets, compared to your competitors, that is the real opportunity to strike—when others are suffering.

09:50 One example of that would be Boyd Group, that we own in the portfolio. It's a collision repair shop chain in North America, it's the second largest player. If you look at the industry, it's split between two players: one part is mom-and-pop players, there's a lot of them, thousands and thousands of them. The second type of players are private-equity-owned chains that have been consolidated in the industry, by acquiring mom-and-pop shops.

10:18 The mom-and-pop shops…I would argue that they are fragile by design. They have less processes, they have lower margins, and they are typically dependent on one or two people that are running these shops. And private equity side is also fragile, because they tend to be levered businesses. Versus Boyd, [which] is very well-positioned in this industry: they are publicly listed, they don't have huge debt levels. Their debt levels are 1.5 times debt to EBITDA, for example, compared to private equity players. (A lot of them are at seven, even more than 10x the debt to EBITDA.)

10:55 We've actually seen one of the players, the number three player, Service King, being downgraded most recently to triple C debt rating, which is just a notch above the default rating. Versus Boyd Group, [which] has really drove down its revolvers, and has raised further capital in the markets—even during these times. They have $700 million cash in the balance sheet.

Samir Taghiyev: So, imagine, going forward: that will be a very good position to be [in], and to acquire either struggling private equity or mom-and-pop players.

Andrew Johnson: **11:30** Okay, so I'm hearing that not only is the balance sheet important in order to survive through something like this, but it can be an incredible asset (no pun intended) on the other side, if we find ourselves in a weakened competitive environment, or if these companies find themselves in a weakened competitive environment.

Samir Taghiyev: **11:47** Exactly.

Andrew Johnson: **11:48** There are a couple other things that I wanted to check-in with you on. One is related to the term resilience that we mentioned earlier, especially the resilience that we've seen from the portfolio lately coming from the software-based businesses that we also mentioned. There are a handful in this portfolio. What is it about those companies that seem to fit within our philosophy so well?

Samir Taghiyev: **12:07** You're right, Andrew, that we do have a lot of these businesses. And they do really hit the nail in terms of the features that we'll look around businesses.

12:16 So, if you think about wealth creation, what does that mean? It's having returns on capital above your costs of capital. Many of the software businesses have high returns on very little capital that is required to run these businesses, so that is one attractive feature.

12:32 The second attractive feature: these tend to be very stable, contractual cash flows. These tend to be very hard to cancel agreements with clients, where they have to retrain their employees, or reconfigure their systems just to change one provider of software to another.

Samir Taghiyev: **12:51** One example of that would be Kinaxis that comes to mind. It is a company based out of Ottawa that specializes in software that helps large multi-national corporations to do scenario analysis on supply chains. So, if you think about it, if I am Unilever, for example, I have thousands and thousands of suppliers. I'm never sure if one of them will be able to deliver the products that they promised to deliver. And if they don't deliver it, how is that going to impact my other parts of the supply chain? That software really comes into play in these times, when [the] supply chain becomes more strained. During COVID, there are more border closure problems, as well as many businesses are not able to operate due to lockdowns, so inventory becomes more scarce and you're staring to have supply chain problems that you've seen in the headlines.

Andrew Johnson: **13:49** The other item that I wanted to discuss a little bit is around the observation that a significant amount of the revenues that are generated by the companies in your portfolio in particular are in U.S. dollars. Why would that be, why is that?

Samir Taghiyev: **14:04** That is a good observation; that has been the case for a while now. We have done several calculations in the past—around half of the portfolio's revenues, really, on a weighted basis come from U.S. dollars. And that is strange, given that we're primarily a Canadian small cap portfolio. I think that is the result of the resilience of many businesses, and the strength of many businesses that we own.

14:30 Many of them start in Canada, they have a Canadian-based headquarters and management teams. They have started their businesses in some province or city of Canada as well, but eventually they saturate Canada, being a smaller market, and eventually move south of the border.

The United States is a very hard market to crack. It is much larger, meaning that there are more competitors that can play in that market, which makes it way more competitive. The margins are typically lower, and there's less of good capital deployment opportunities in the U.S. for a typical business.

15:09 Now, not many Canadian businesses have been able to do that shift from Canada to the U.S. If you think about Tim Hortons, for example, tried to deploy their chain throughout the U.S. as well—that didn't go well. It seems to be a hard challenge to do. Versus some of our portfolio holdings have historically tried it, and the ones that tried out and succeeded just found a new opportunity, new runway, to deploy capital, and to have growth.

Samir Taghiyev: 15:37 One example of this would be Richelieu Hardware. They started out in Montreal, and they're a distributor of hardware. If you think about knobs, or other hardware items that you would use in architecture, or around your home in renovations. They started consolidating first the Montreal market, then the Quebec market, then the Canadian market. After that, the founder and manager of that business, Richard Lord, started moving to the U.S., and has found that runway, which has been, really, the algorithm for now for the wealth-creation, which is to buy independent distributors in the U.S. and plug into their network.

Andrew Johnson: 16:21 You'll be happy to hear that I've supported the portfolio recently, because I just went through the arduous process of replacing all of the knobs on our kitchen cabinets, which was both a fun and a learning experience for me.

Samir Taghiyev: 16:34 Good, thank you [laughter].

Andrew Johnson: 16:35 What I'm hearing, Samir, is that having that U.S. dollar exposure in the portfolio is not necessarily a top-down decision, it's just more bottom-up; it's more of a characteristic of a strong business that we're actually looking for.

Samir Taghiyev: 16:46 Exactly. So, here at Mawer, we very rarely tend to do very top-down decisions. Top-down decisions that we make tend to be around risk. If we see that we have too much of a certain sector, or a certain risk exposure in our portfolio, that would be a good top-down decision to have for portfolio conservation reasons.

17:08 Other than that, most of our decisions tend to be very bottom-up. So we have one philosophy across all of our funds, which is to buy wealth-creating businesses with good balance sheets, run by good management teams that are aligned, and not overpaying for these stocks. And following that process for each of our investment decisions really results in this portfolio that is more aligned in more resilient businesses, businesses that have more USD revenue exposure, or businesses that don't have much balance sheet problems.

Andrew Johnson: 17:45 One very common question that we get from clients, and I'd be remiss if I didn't ask it to basically everybody that I interview on the podcast, is around our general state of valuations when we're looking across the portfolio, as well as the market. So I just wanted to ask you, what's your view on valuations today?

Samir Taghiyev: 18:02 Valuations are a very blunt tool. Even on a company basis, we do our valuations on DCF basis, which is trying to forecast the cash flows that we think we will get from this business in the future and discounting it to the present moment. But these models also tend to be very sensitive to assumptions, so that's why we do a sensitivity analysis on our valuations as well. Just being cognizant that valuation is a very blunt tool, and most of the time it's very hard to say. The same is true for the portfolio as well. We only have a very soft idea of whether the portfolio is cheap, or expensive, or fairly valued.

18:43 I would say that it's hard to tell now, but relatively speaking, the portfolio is flat year-over-year. In that period of time, we've had a huge risk coming up, which is the pandemic; the risks for many of the businesses have increased. I think that with this pandemic, we'll see a lot of the secondary effects—the economic effects of it—really, by the second half of the year, or further. That can be more strained balance sheets, or lower confidence levels by the consumers. And that increases the risk for many of the businesses while the valuation levels have stayed the same. That is the result of the injected liquidity by the central banks into the system.

19:24 So overall, I would say that, yeah, the valuations are now about the same, but the risk levels have increased.

Andrew Johnson: 19:31 Yeah, I think what it highlights for me, when we talk about valuations, is really valuations is about really trying to predict the future, and all of the information that you have is about the past.

Samir Taghiyev: 19:41 Exactly. We're trying to extrapolate future out of our knowledge of the past of the business, and the present of the business.

Andrew Johnson: 19:48 I always like to end just by highlight an example of a stock in the portfolio, that can be used to illustrate our philosophy and our process. Just given that we've chatted a bit about software companies earlier, the largest holding that we have in that industry is Enghouse. So, what does Enghouse do, and what do we find attractive about it?

Samir Taghiyev: 20:07 So Enghouse, as you said, it's a software business. There's a lot of different software niches that they operate in—about half of their revenue is in contact centre software. So, think of when you call your telecom provider, for example, and you're trying to get reach of the agent. Well, you will first dial certain numbers on your phone, answering questions that way. Well, that software is probably Enghouse. And talking to the agent as well, that's also powered by Enghouse.

Samir Taghiyev: 20:35 The other half of the software is behind-the-curtains infrastructure management for telecom companies. So, think about [if] you have a 4G phone, there's a lot happening behind the curtains on connection of that phone, to the infrastructure of your provider. So for management of that, that's where Enghouse's software comes into play as well.

20:59 What we like about this business is, really, these are very sticky software business models. [A] contact centre, imagine, changing [a] contact centre—that would make very big disruptions into your business. A lot of the customers will not be happy. Those customers tend to be very sticky, and they change their providers not often. And infrastructure for telecom is the same—people don't want disruptions to their phones.

21:25 Another thing that we like about this business is, really, the management team. It's run by Steve Sadler, who owns 13% of the business, has been running this business, really, for a few decades now, which is impressive. And what he's been doing is acquiring different software businesses that are attractive, that really follow our philosophy as well, at very attractive valuations and integrating them and running them better under this one umbrella.

Andrew Johnson: 21:54 Well, I'm not sure if we can find a better example of the "Be Boring. Make Money. TM" approach than software for call centres and infrastructure of running a telecom business. I think you nailed that one, so thank you. I also just want to thank you, Samir, for joining us for the first time, and hopefully not the last time. So, I'm looking forward to speaking to you again in the future.

Samir Taghiyev: 22:12 Oh, thanks for hosting, thanks for having me.